



JAIIB (New Syllabus)

**INDIAN ECONOMY &
INDIAN FINANCIAL SYSTEM
(IE&IFS).**

Paper-1

MODULE-B, UNIT-6



**MONETARY POLICY AND FISCAL
POLICY**

JAIIB IE & IFS Module B Unit 6: Monetary Policy and Fiscal Policy

Monetary Policy

Monetary Policy is the process by which the Government, Central Bank controls

- The money supply
- Availability of money
- Cost of money or rate of interest

In order to attain a set of objective oriented towards the growth and stability of the economy. Monetary policy is referred to as either being **expansionary policy** or a **contractionary policy**.

Expansionary policy

- An expansionary policy increases the total supply of money in the economy. This is used to combat unemployment in a recession by lowering interest rates.

Contractionary policy

- A contractionary policy decreases the total money supply. This is used to combat inflation by raising the interest rates.

Tools of Monetary policy:

- Bank Rate
- Cash Reserve Ratio
- Statutory Liquidity Ratio
- Market Stabilization Scheme
- Repo Rate
- Reverse Repo Rate
- Open Market Operations

- Marginal Standing Facility (MSF)
- Standing Deposit Facility (SDF)
- Base Rate
- Marginal Cost of Funds based Lending Rate (MCLR)
- External Benchmark Lending Rates (EBLR)

Bank Rate

- **Section 49 of the RBI act, 1934 is as follows:** “**Publication of bank rate.** The Bank shall make public from time to time the standard rate at which, it is prepared to buy or re-discount bills of exchange or other commercial papers eligible for purchase under this Act.” Simplistically put, it is the rate of interest paid by banks to RBI, on their long-term borrowings.
- It is also referred as Discount rate, is the rate of interest which a central bank charges on the loans and advances that it extends to commercial banks and other financial intermediaries.

Bank Rate as an instrument of Monetary policy has been very limited in India because of these basic factors:

- The Structure of interest rates is not automatically linked to the bank rate
- Commercial banks enjoy specific refinance facilities, and not necessarily rediscount their eligible securities with RBI at Bank rate
- The bill market is under-developed and the different sub-markets of the money market are not influenced by the bank rate.

Marginal Standing Facility (MSF)

- It is a facility under which, scheduled commercial banks can borrow additional amount of overnight money from the **RBI, by dipping into their SLR portfolio**, up to a limit (currently two per cent of their NDTL outstanding at the end of the second preceding fortnight) at a penal rate of interest (**currently 25 basis point above the repo rate**).
- This provides a safety valve against unanticipated liquidity shocks to the banking system. MSF rate and reverse repo (presently SDF (Standing Deposit Facility Rate is the lower band of the LAF corridor) rate determine the corridor for the daily movement in short-term money market interest rates.

Different Between Bank Rate and MSF

BASIS FOR COMPARISON	BANK RATE	MSF RATE
Meaning	Bank Rate is a discount rate at which RBI grants long term loans to commercial banks.	MSF Rate is a rate at which the commercial banks borrow funds overnight from the central bank.

Eligibility	All commercial banks.	All Scheduled Commercial Banks (SCBs) having their current account and Subsidiary General Ledger (SGL) with an RBI.
Meant for	Long term Lending	Overnight Lending
Collateral	The loan can be raised without pledging the securities.	The loan is given against security within the limits of SLR and up to a certain percentage of NDTL.
Objective	To manage and control credit supply in the country.	To provide funds to the banks overnight, when they face an acute shortage of funds.

Cash Reserve Ratio (CRR):

- The present banking system is called a “**Fractional Reserve Banking System**, as the banks are required to keep only a fraction of their deposit liabilities in the form of liquid cash with the central bank for ensuring Safety and liquidity of deposits.
- **CRR was introduced in 1950** primarily as a measure to ensure safety and liquidity of bank deposits.
- This **minimum ratio** (that is the part of the total deposits to be held as cash) is **stipulated by the RBI and** is known as the CRR or Cash Reserve Ratio.
- **The 2006 amendment bill to the Reserve Bank of India Act** for providing flexibility to the RBI, in fixing the CRR removed the cap and the range of CRR between **3% and 20% of a bank’s NDTL**.

Statutory Liquidity Ration (SLR):

- **SLR refers to the amount that all banks requires maintaining in cash or in the form of Gold or approved securities.** Approved securities mean dated securities, government bonds, and share of different companies.
- The SLR is determined as % of **Total Demand and Time Liabilities**
- **SLR defined by RBI as All Scheduled Commercial Banks**, in addition to the average daily balance which they are required to **maintain under Section 42 of the RBI Act, 1934**, are required to maintain in India, in cash, or in gold valued at a price not exceeding the current market price, or in unencumbered approved securities valued at a price as specified by the RBI from time to time.
- An amount of which shall not, at the close of **the business on any day**, be less **than 18%** or such other percentage **not exceeding 40%** as the RBI may from time to time, by notification in gazette of India, specify, of the total of its demand

and time liabilities in India as on the last **Friday of the second preceding fortnight**.

- At present (**1st June 2022**), all **Scheduled Commercial Banks** are required to maintain a uniform **SLR of 18 per cent of the total of their demand and time liabilities in India as on the last Friday** of the second preceding **fortnight** which is stipulated under section 24 of the **B.R. Act, 1949**.

Demand Liabilities

- Demand Liabilities' include all liabilities which are payable on demand and they include current deposits, demand liabilities portion of savings bank deposits, margins held against letters of credit/guarantees, balances in overdue fixed deposits, cash certificates and cumulative/recurring deposits, outstanding Telegraphic Transfers (TTs), Mail Transfer (MTs), Demand Drafts (DDs), unclaimed deposits, credit balances in the Cash Credit account and deposits held as security for advances which are payable on demand. Money at Call and Short Notice from outside the Banking System should be shown against liability to others.

Time Liabilities.

- Time Liabilities are those which are payable otherwise than on demand and they include fixed deposits, cash certificates, cumulative and recurring deposits, time liabilities portion of savings bank deposits, staff security deposits, margin held against letters of credit if not payable on demand, deposits held as securities for advances which are not payable on demand and Gold Deposits.

Different between CRR and SLP

BASIS FOR COMPARISON	CRR	SLR
Meaning	CRR is the amount of money that the banks are obligated to park with the central bank, in the form of cash.	SLR is the amount of funds which the banks are required to maintain as liquid assets, i.e. cash, gold, approved securities. etc.
Regulates	Monetary stability in the country	Bank's leverage for credit expansion
Use	To drain out excess money out of the economic system.	To ensure the solvency of the commercial bank.
Maintenance with	Central Bank of India i.e. RBI	Bank itself
Form	Cash and cash equivalents	Liquid Assets

Return	Banks don't earn any interest as return on the money kept as CRR.	Banks usually earn interest as return on the funds kept as SLR.
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Standing Deposit Facility (SDF)

- The **SDF allows banks to deposit money with the RBI on an overnight basis**. But the RBI has the option, should the need arise, to absorb liquidity for longer tenors under the SDF with proper pricing. The SDF scheme would be open to all participants in the liquidity adjustment facility (LAF). **In 2018, the amended Section 17 of the RBI Act** empowered the Reserve Bank to introduce the Standing Deposit Facility (SDF).

Note: Deposits under the **SDF is not considered as balances eligible for the maintenance of the CRR under Section 42 of the RBI Act, 1934**, but shall be an eligible asset for maintenance of the SLR under Section 24 of the Banking Regulation Act, 1949.

Market Stabilization Scheme:

- RBI introduced Market Stabilization Scheme after consulting GOI for mopping up liquidity of a more enduring nature. Under this scheme, the **GOI issue existing instrument, such as Treasury Bills/ and or dated securities** by way of auctions under the MSS, in addition to the normal borrowing requirements, for absorbing liquidity from the system.

Base Rate:

- The RBI has introduced the Base Rate system with **effect from July 1, 2010**, by replacing the Benchmark Prime Lending Rate (BPLR) system.
- **Base rate is defined as the minimum interest rate set by the RBI below which Indian banks are not permitted to lend to their customers**. Unless there is a government mandate, the RBI rule specifies that no bank may offer loans at an interest rate lower than the base rate.

Marginal Cost of Funds based Lending Rate (MCLR)

- **Marginal Cost of Funds based Lending Rate (MCLR) is the minimum lending rate below** which a bank is not permitted to lend. MCLR replaced the earlier base rate system to determine the lending rates for commercial banks.
- **RBI implemented MCLR on 1 April 2016** to determine rates of interests for loans.

External Benchmark Lending Rates (EBLR)

- Based on the recommendations of the Internal Study Group (ISG) to Review the Working of the **Marginal Cost of Funds Based Lending Rate (MCLR) System** headed by **Dr. Janak Raj**, that was formed by the RBI to examine various aspects of the MCLR system.
- It was noticed that internal benchmarks such as the Base rate/MCLR have not delivered effective transmission of monetary policy. As a result, the Study Group advised a time-bound transition to an external benchmark. The RBI has recommended banks to benchmark all new floating rate personal or retail loans (housing, vehicle, etc.)
- Floating rate loans to Micro and Small Enterprises extended by banks beginning **October 1, 2019**.

To one of the following;

- Reserve Bank of India policy repo rate
- Government of **India 3-Months Treasury Bill yield**, published by the Financial Benchmarks India Private Ltd (FBIL)
- Government of **India 6-Months Treasury Bill yield**, published by the FBIL
- Any other benchmark market interest rate, published by the FBIL.

Repo Rate:

- **Repo (Repurchase) rate is the rate at which RBI lends short-term money to the banks.** Bank lending rates are determined by the movement of Repo Rate.

Reverse repo: "Reverse repo" is an instrument for lending funds by purchasing securities with an agreement to resell the securities on a mutually agreed future date at an agreed price which includes interest for the funds lent.

Tri-party repo or TREPS : Tri-party repo or TREPS is a type of repo contract where a third entity (apart from the borrower and lender), called a tri-party agent, acts as an intermediary between the two parties to the repo to facilitate services like collateral selection, payment and settlement, custody and management during the life of the transaction.

Triparty repo was introduced on November 5, 2018. CBLO has been discontinued from November 2018.

Special long term repo operation (SLTRO)

The Reserve Bank of (RBI) will be conducting one special long term repo operation (SLTRO) for small finance banks (SFB) for **each month, totalling Rs 10,000 crore.**

About

- To provide further support to small business units, micro and small industries, and other unorganised sector entities adversely affected during the current wave of the pandemic, the RBI has decided to conduct **SLTRO of ₹10,000 crore at the repo rate for the SFBs, to be deployed for fresh lending of up to ₹10 lakh per borrower.**

- The SLTRO will be valid for three years. All SFBs will be eligible to participate in the scheme.
- The SFBs will have to ensure that the amount borrowed from the RBI should at all times be let to the specified segments, namely small business units and other unorganised sectors impacted by the pandemic.
- SLTROs will be conducted on CBS (E-KUBER) platform. The operations would be conducted at a fixed rate. Banks would be required to place their requests for the amount sought under SLTRO during the window timing at the prevailing policy repo rate. Bids below or above policy rate will be rejected.

Term Repo

- Since October 2013, the RBI has introduced term repos (of different tenors, such as, 7/14/28 days), to inject liquidity over a period that is longer than overnight.
- **The aim of term repo** is to help develop interbank money market, which in turn can set market-based benchmarks, for pricing of loans and deposits, and through that improve transmission of monetary policy.
- **During 2019, to ensure the smooth transmission** of monetary policy and flow of credit to the economy, **RBI introduced Long-Term Repo Operations (LTROs)** of one-year and three-year tenors. When longterm repo operations (LTROs) were introduced to facilitate monetary transmission and support credit offtake, RBI has also used another unconventional tool i.e., targeted long-term repo operations (TLTROs) to provide liquidity to specific sectors and entities experiencing liquidity stress.

Reverse Repo Rate:

- **Reverse Repo Rate** is the rate at which banks park their **short term excess liquidity with the RBI**. The RBI uses this tool when it feels there is too much money floating in the Banking System.
- An **Increase in Reverse Repo** means that the **RBI will borrow money from the Banks at a higher rate of interest**, so banks would prefer to keep their money with the RBI.

Variable Rate Reverse Repo (VRRR)

- The VRRR is usually undertaken to reduce the money flow by taking out existing cash present in the system. The central bank has been rebalancing the surplus liquidity in the system by shifting it out of the fixed-rate overnight reverse repo window to VRRR auctions of longer maturity.

Open Market Operations:

- Under this, RBI buys or sells government bonds in the secondary market. By absorbing bonds, it drives up bond yields and injects money into the market. When it sells the bonds, it does so such the money out of the system.

Refinance Facilities:

RBI Provide Sector- specific refinance facilities aimed at achieving **sector specific objectives through provision of liquidity at a cost linked** to the policy repo rate.

Liquidity Adjustment facility (LAF):

- A LAF is a monetary policy tool used in India by the RBI through which it injects or absorbs liquidity into or from the banking system.
- It was introduced as a part of the outcome of the **Narasimham Committee on Banking Sector Reforms of 1998**.
- LAF has two components - repo (repurchase agreement) and reverse repo. When banks need liquidity to meet its daily requirement, they borrow from RBI through repo. The rate at which they borrow fund is called the repo rate. When banks are flush with fund, they park with RBI through the reverse repo mechanism at reverse repo rate.
- It can manage inflation in the economy by increasing and reducing the money supply.

RBI's monetary policy's objectives:

- Monitor the global and domestic economic conditions and respond swiftly as required.
- Ensure higher bank credit expansion to achieve higher growth but at the same time protect the credit quality
- Maintain price stability and financial stability
- Give thrust on Interest Rate Management, Inflation Management and Liquidity Management.

Reserve Bank's Monetary Policy

What is Monetary Policy Framework?

About:

- In May 2016, the **RBI Act was amended to provide a legislative mandate** to the central bank to operate the country's monetary policy framework.

Objective:

- The framework aims at **setting the policy (repo) rate based on an assessment of the current and evolving macroeconomic situation**, and modulation of liquidity conditions to anchor money market rates at or around the repo rate.
- **Reason for Repo Rate as Policy Rate:** Repo rate changes **transmit through the money market to the entire financial system**, which, in turn, influences aggregate demand.
- Thus, it is a key **determinant of inflation and growth**.

What is the Monetary Policy Committee?

- **Origin:** Under Section 45ZB of the amended (in 2016) RBI Act, 1934, the central government is **empowered to constitute a six-member Monetary Policy Committee (MPC)**.
- **Objective:** Further, Section 45ZB lays down that “the Monetary Policy Committee shall determine the Policy Rate required to achieve the inflation target”. The decision of the Monetary Policy Committee shall be binding on the Bank.
- **Composition:** Section 45ZB says the MPC shall **consist of 6 members:**
 - RBI Governor as its ex officio chairperson,
 - Deputy Governor in charge of monetary policy,
 - An officer of the Bank to be nominated by the Central Board,
 - Three persons to be appointed by the central government.

Note: This category of appointments must be from “persons of ability, integrity and standing, having knowledge and experience in the field of economics or banking or finance or monetary policy”.

What are the Instruments of Monetary Policy?

- Repo Rate
- Standing Deposit Facility (SDF) Rate
- Marginal Standing Facility (MSF) Rate
- Liquidity Adjustment Facility (LAF)
- LAF Corridor
- Main Liquidity Management Tool
- Fine Tuning Operations
- Reverse Repo Rate
- Bank Rate
- Cash Reserve Ratio (CRR)
- Statutory Liquidity Ratio (SLR)
- Open Market Operations (OMOs)

What is an Expansionary Monetary Policy?

About:

- An expansionary monetary policy is **focused on expanding (increasing) the money supply** in an economy. This is also known as Easy Monetary Policy.
- It is implemented by **lowering key interest rates thus increasing market liquidity** (money supply). High market liquidity usually encourages more economic activity.
- When RBI adopts **Expansionary Monetary Policy**, it decreases **Policy Rates (Interest Rates)** like Repo, Reverse Repo, MSF, Bank Rate etc.

Implications:

- Causes an **increase in bond prices** and a reduction in interest rates.
- Lower interest rates lead to **higher levels of capital investment**.

- The lower interest rates **make domestic bonds less attractive**, so the demand for domestic bonds falls and the demand for foreign bonds rises.
- The **demand for domestic currency falls** and the demand for foreign currency rises, causing a decrease in the exchange rate. (The value of the domestic currency is now lower relative to foreign currencies)
- A lower **exchange rate causes exports to increase**, imports to decrease and the balance of trade to increase.

What is Contractionary Monetary Policy?

About:

- A contractionary monetary policy is **focused on contracting (decreasing) the money supply** in an economy. This is also known as **Tight Monetary Policy**.
- A contractionary monetary policy is implemented **by increasing key interest rates thus reducing market liquidity (money supply)**. Low market liquidity usually negatively affects production and consumption. This may also have a negative effect on economic growth.
- When RBI adopts a contractionary monetary policy, it increases Policy Rates (Interest Rates) like Repo, Reverse Repo, MSF, Bank Rate etc.

Implications:

- Contractionary monetary policy **causes a decrease in bond prices** and an increase in interest rates.
- Higher interest rates **lead to lower levels of capital investment**.
- The higher interest rates make domestic bonds more attractive, so the demand for domestic bonds rises and the demand for foreign bonds falls.
- The demand for domestic currency rises and the demand for foreign currency falls, causing an increase in the exchange rate. (The value of the domestic currency is now higher relative to foreign currencies)
- A **higher exchange rate causes exports to decrease**, imports to increase and the balance of trade to decrease.

Fiscal Policy

- In economics and political science, **fiscal policy** is the **use of government revenue collection and expenditure to influence a country's economy**.
- Fiscal policy can be contrasted with the other main type of economic policy, monetary policy, which attempts to stabilize the economy by controlling interest rates and supply of money. **The two main instrument of fiscal policy are government spending and taxation**. Changes In the level and composition of taxation and government spending can have impact on the following variable in the economy. **J. M. Keynes was the first economist to propose a theory that linked fiscal policy and economic performance**.
- Aggregate demand and the level of economic activity
- The pattern of resources allocation
- The distribution of income

- Fiscal Policy is the use of government spending and revenue collection the economy. Fiscal Policy refers to the overall effect of the budget outcome on economic activity.

Taxation and its impact on the Economy

Taxes have a direct impact on people's income, influencing their levels of disposable income, expenditure on goods and services, consumption, and, ultimately, their standard of living.

- Taxes directly affect the savings of individuals, families, and firms, which affect investment in the economy—as investment affects output, influencing per capita income.
- Taxes impact the prices of goods and services because they alter production costs, which affect incentives and economic activity behaviour, among other things.

Objectives of Fiscal Policy in India

Primary objectives

- Promoting economic growth
- Maintaining price stability in the economy

Additional objectives

- Mobilizing resources
- Promoting allocative efficiency
- Reducing inequality in income and wealth
- Promoting private sector investment

FRMB Act

- **Fiscal Responsibility and Budget Management Act – 2003.** Dr E A S Sharma Committee January, 2000 recommended draft legislation on fiscal responsibility.

FRBM requirements are

- The Government to place before Parliament 3 statement each year along with Budgets, Covering Medium Term Fiscal Policy, Fiscal Policy Strategy and Macroeconomic Framework
- Center to reduce the fiscal deficit (Generally 3% of GDP) and more categorically to 'Eliminate revenue deficit' by 31-03-2008. Government to set a ceiling on guarantee (0.5% of GDP)
- Act prohibits the Center from borrowing from the RBI, i.e. it bans 'Deficit financing' through money creation. The RBI is also barred from subscribing to primary issues of Central Government Securities.

- The Finance Minister is required to keep Parliament informed through quarterly review on the implementation, and to take corrective measure.
- The main theme of the FRBM Act is to reduce the dependence of the Government on borrowings and help to reduce the fiscal deficit in a phased manner.

The main objectives of the FRBM Act were

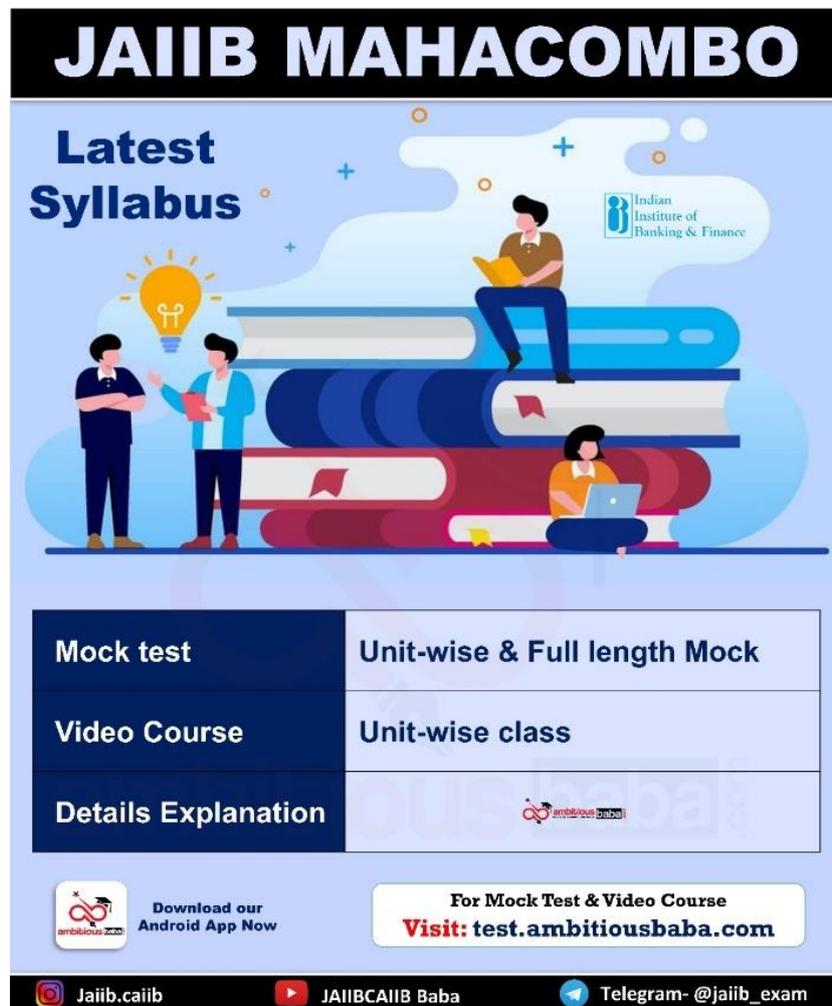
- To achieve long-term macro-economic stability, while generating budget surpluses
- To introduce prudential debt management
- To introduce transparent fiscal management systems in the country and
- To remove fiscal impediments and providing a medium-term framework for budgetary implementation.

N.K. Singh Committee on FRBM

Government of India appointed a **high-level committee to review the FRBM Act, 2003**. The committee submitted its report in January 2017. **Following are the important recommendations of the committee.**

- Debt should be used as the primary target for fiscal policy. **A debt-to-GDP ratio of 60% should be targeted with a 40% limit for the center and 20% limit for the states and the targets should be achieved by 2023.** To achieve the targeted debt-to-GDP ratio, the committee proposed yearly targets to progressively reduce the fiscal and revenue deficits, till 2023.
- An autonomous Fiscal Council **must be created** with a chairperson and two members appointed by the center. The role of the Council would include (i) preparing multi-year fiscal forecasts, (ii) recommending changes to the fiscal strategy, (iii) improving quality of fiscal data, (iv) advising the government if conditions exist to deviate from the fiscal target, and (v) advising the government to take corrective action for non-compliance with the Bill.
- The government may be allowed to deviate from the specified targets upon the advice of the Fiscal Council in the following circumstances: (i) considerations of national security, war, national calamities and collapse of agriculture, affecting output and incomes, (ii) structural reforms in the economy, resulting in fiscal implications, or (iii) decline in real output growth of at least 3% below the average of the previous four quarters. These deviations cannot be more than 0.5% of GDP, in a year.
- The 15th Finance Commission should be asked to recommend the debt trajectory for individual states. This should be based on their track record of fiscal prudence and health.
- Government cannot borrow from the RBI except when (i) the center has to meet a temporary shortfall in receipts, (ii) the RBI subscribes to government securities to finance any deviations from the specified targets, or (iii) the RBI purchases government securities from the secondary market.

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